BASELINE ISSUE 9: EQUALIZATION OF REGULATIONS FOR LECS AND CAPS

Baseline Issue 9a: Whether the Commission's current rules for computing AT&T's exogenous access costs should be revised to equalize the treatment of LEC and CAP access rates in the calculation of AT&T's exogenous access costs.

In its comments, MCI argued that AT&T should be allowed to retain any benefits associated with efficiency gains realized if it selects a new access vendor who provides services at a lower cost than AT&T previously paid.[184] MCI also believes, however, that AT&T should be required to treat as exogenous any changes in the rates that its current access provider charges.[185]

The LECs predictably argue that "[t]he Commission should require AT&T to treat its payment of access charges to LECs or CAPs the same way."[186] LECs argue for parity in AT&T access charge treatment on the basis that the current treatment creates a "non-economic bias [that] places the LEC at an artificial disadvantage."[187] They bemoan the "artificial incentive" that the prescribed regulatory treatment of CAP access charges creates to encourage

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[184] MCI Comments, p. 58.

[185] Id.

[186] GTE Comments, p. 65, see also Ameritech Comments, p. 38; Bell Atlantic Comments, p. 29; BellSouth Comments, pp. 66-67; NYNEX Comments, p. 50; Pacific Telesis Comments, p. 66; Southwestern Bell Comments, p. 58; USTA Comments, p. 89; and US WEST Comments, p. 58.

[187] USTA Comments, pp. 89-90. See also Bell Atlantic Comments, p. 29, (footnote omitted).

IXCs to turn to these non-LEC service providers.[188] The purpose of this position is clear: requiring AT&T to pass-through the cost savings realized by switching to a CAP, as well as future access cost reductions, facilitates LEC retention of their monopoly on the transport market.

LECs attempt to substantiate their contentions by claiming also that "access competition [has] increased substantially."[189] This simply is not the case. As MCI has stated previously, competitive access providers deliver less than 1 percent of the access services that IXCs purchase.[190] With its cost incentive offset by the additional administrative burden of calculating the cost differential between its current and proposed access rates, AT&T would have significantly less motivation to seek out a lower cost alternative to the LEC.[191] As long as access competition is in its nascent stage, requiring AT&T to pass through any cost savings realized from switching to a lower cost CAP will essentially strangle the baby in its crib.

Should the Commission decide to reform its theory of exogenous costs as MCI suggests, to treat only jurisdictional changes as exogenous, it must confront

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[188] See, e.g., USTA Comments, p. 89; Bell Atlantic Comments , p. 29, (footnote omitted); and GTE Comments, p. 66.

[189] Pacific Telesis Comments, p. 65.

[190] MCI Comments, p. 65.

[191] Under these circumstances, the only possible inducement AT&T might have to change access carriers would be if the CAP offered better service. If the service quality differential were so great that AT&T would change carriers despite the administrative burden the LECs envision for it, MCI would recommend that the Commission re-evaluate the service quality monitoring reports.

the issue of how to treat access charges for AT&T. Changes in access charges do not shift dollars into or out of the interstate jurisdiction. If the Commission adopts for AT&T the same exogenous cost theory that MCI urges the Commission to adopt for the LECs, access charge changes would no longer be considered exogenous.

MCI believes that this issue is outside the scope of the instant proceeding, and would have to be separately "noticed" as a rule change for AT&T. The Commission is therefore left -- for some period of time -- in the awkward position of having two different exogenous cost rules based on two different theories. However, the LEC and AT&T exogenous cost rules are already contained in separate sections of the Commission's Rules (i.e., Sections 61.44 and 61.45), and there may be policy reasons that support a decision to treat AT&T differently from the LECs.

In the interim, before the Commission could examine exogenous cost reform for A&T, MCI believes that AT&T should calculate as exogenous those access rate changes it receives from its access provider. However, AT&T should not be required to treat as exogenous cost changes resulting from switching to a different access provider because of the administrative burden associated with such a condition. That is, the regulatory disparity that LECs envision correcting by requiring AT&T to pass through cost reductions realized from switching to a CAP for access services is impossible to verify and exacts too great an administrative burden to implement, even if the Commission wished. An examination of the mechanism that would be used to calculate any pass-through of expenses confirms this assertion. Further, to comply with the LECs' wish that AT&T pass through access expense changes associated with switching to a CAP, AT&T would have to approximate the historical access demand which would migrate to the CAP service. If the LECs and CAPs had different rate structures, this calculation would be even more difficult for AT&T to make. Finally, not only would this demand calculation be speculative, but there is no way to verify AT&T's estimate.

<u>Baseline Issue 9b</u>: Whether any other rules or policies that relate to LEC price cap regulations should be revised to equalize Commission treatment of LECs and CAPs, and if so, what the revised rules and policies should be.

Because LECs continue to be the dominant local service and access providers in their respective geographic franchise territories -- and will continue to be for the foreseeable future -- it is both unnecessary and inappropriate to contemplate changes to the regulatory system that would put LECs on equal regulatory footing with CAPs.[192] The LECs, however, attempt to use the threat of competition as a rallying force to justify premature relaxation of LEC regulatory requirements. If regulation is eased before local service and access providers have the opportunity to firmly establish themselves within the market, the LECs will retain the ability to thwart emerging competitors. If competitive access provision is defeated before it ever really gets started, ratepayers will be deprived

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[192] MCI Comments, p. 59.

of the benefits derived from competition. Precipitous relaxation of LEC regulations (or inverse tightening of CAP regulations) is not just inappropriate, it is imprudent and will lead to the continued monopolization of interstate access.

Nonetheless, the LECs appeal for equal treatment for most of the major regulatory components: greater pricing and rate structure flexibility, reduced tariff notice periods, cost support, and demand data reporting; higher depreciation expenses; and the elimination of excess profit sharing.[193] Ironically, the LECs seek regulatory symmetry "so as not to skew the competitive process."[194] Such a biased focus fails to recognize that it is the LECs who started with 100 percent share of the intestate access market, and that it is their entrenched historical monopoly power that skews the market in their favor and makes it difficult for potential competitors to enter the market at all, much less gain equal footing. While the LECs may seek regulatory parity in the name of competition, it must be recognized that their goal is really maintenance of the status quo and retention of the profits they historically have achieved in monopoly markets.

In their individual markets, LECs retain dominant carrier status. LECs obtained franchise rights from local municipalities, and except for some rural areas, the LECs provide service ubiquitously within their assigned territories. It is thus common knowledge that LECs have facilities virtually everywhere. In their

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[193] See USTA Comments, pp. 90-91.

[194] Ameritech Comments, p. 28. See also BellSouth Comments, p. 67 (LEC ability to stand on equal footing with their competitors requires ability to offer services in the same way that their competitors do).

quest for regulatory parity, the LECs now seek a Commission mandate that CAPs file detailed service area descriptions as part of their interstate tariff filings.[195] Although the LECs clothe this proposition as information that is necessary for the Commission to "analyze markets and market power,"[196] it is not difficult to recognize the wolves lurking underneath. Pacific seeks information detailed to the degree that the CAP plans would indicate "whether a customer at a given address has a competitive choice."[197] Southwestern Bell requests network facilities maps, "including planned additions for the following annual period."[198] What the LECs are truly seeking is a low-cost way to target their rate reductions to the individual serving wire centers where competition is beginning to evolve. Such a response would reflect market-based, not cost-based rates, an occurrence which the Commission has rejected before, and it should reject again. Simply put, non-dominant new competitors should not have to list their planned service offering areas. To require such reporting would devastate emerging competition by allowing the dominant LECs to eliminate the CAPs.

If the Commission nonetheless requires CAPs to file reports disclosing customer-specific marketing plans, MCI urges the Commission to ensure that

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[195] See, e.g., Southwestern Bell Comments, p. 59, (footnote omitted); USTA Comments, p. 91; US WEST Comments, p. 63; and Pacific Telesis Comments, p. 69.

[196] Pacific Telesis Comments, p. 69.

[197] Id. at 69.

[198] Southwestern Bell Comments, p. 59.

such information is given proprietary treatment and is available only for the Commission to make judgments regarding the extent of competition in any given telecommunications market. There is no difference between the Commission making unilateral decisions based on the cost information BOCs provide under SCIS and basing market analysis on data that the LECs are not able to review. Only in this way would the LECs' meet their stated goals of using such information for determining when competitive benchmarks have been reached,[199] without jeopardizing the future of those very competitors.

LECs' pleas for parity of pricing flexibility cannot be taken seriously. USTA contends that "unequal treatment in pricing flexibility places LECs at a substantial competitive disadvantage. . . [and] limits [their] ability to compete with the CAPs for the customer's business,"[200] but it is difficult to fathom how LECs can be at a competitive disadvantage when they retain over 99 percent of the access market. NYNEX seeks pricing flexibility to respond to the "significant competition from CAPs, IXCs and cable companies,"[201] yet this competition has not materialized. If LECs get the pricing flexibility they seek, it likely never will.

More important, LECs have already been granted significant pricing flexibility, some of which they appear not to need. First, analysis of the recent

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199 See Comments of US WEST, p. 58 (seeking competitive data for establishing rules to align regulation with competitive alternatives on market-specific basis).

200 USTA Comments, p. 90.

201 NYNEX Comments, p. 20.

BOC annual access filings indicates that they have failed to reduce prices to the maximum extent that price cap rules permit.[202] In no case did a BOC decrease the SBI for any basket by the maximum 5 percent that price cap rules allow.[203] More significantly, with the exception of GTE, MCI cannot recall another price cap LEC which has filed requests for significant below-band pricing. Such a pattern would indicate that the LECs were facing some competition. Finally, the Commission has granted zone pricing for special access services,[204] the only access component for which there has been any competition, but the LECs have taken only minimal advantage of the new rules.

Similarly, LECs seek additional rate structure flexibility (i.e., the elimination of existing Part 69 waiver process). For example, Bell Atlantic specifically recommends that the Commission "modify its rules to eliminate the codification of any particular rate structure, let alone a rate structure prescribed over 10 years

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[202] MCI assumes that the LECs are not concerned with pricing flexibility to increase rates, but to decrease rates to compete with alternative access providers.

[203] Data derived from the 1994 annual access fling illustrates this point. Five of the BOCs set CCL rates equal to the cap; NYNEX and US WEST reduced CCL rates 4.3% and 3.3%, respectively. Similarly, 5 BOCs decreased their traffic sensitive actual price index by less than .4%, while Ameritech and US WEST reduced theirs by only 2.7% and 1.8%. Finally, 3 BOCs decreased their trunking PCI by less than 1%, while Ameritech, NYNEX, Southwestern Bell and US WEST made modest reductions of 3.9%, 1.4%, 1.1%, and 3.2%. What is significant about these reductions is that 70% of them applied to the non-competitive interconnection charge, and not to the arguably more competitive transport services.

[204] Expanded Interconnection Order, 7 FCC Rcd at 7451.

ago."[205] The LECs claim that the limited rate flexibility combined with the Part 69 waiver process "produce[] delays of a year or more to introduce new switched access services,"[206] and diminish the effect of price cap incentives "because the Part 69 rules operate to delay . . . the introduction of new and innovative service capabilities."[207] Yet, the LECs fail to acknowledge the continued bottleneck control that they maintain over both switching and the local loop (or that competition for transport is not even available in many markets). In light of the LECs' dominance, it is necessary for the Commission to balance its need for retaining any regulation against the potential burden the regulation could have on the parties subject to it.

There clearly is a significant need for the Commission to mandate the LECs rate structure. Although MCI believes that Part 69 rules do not go far enough in unbundling services, they do provide some degree of control of the LECs' ability to bundle different service offerings together in the future.[208] Absent rate design constraints or the opportunity for interested parties to review Part 69 waiver requests, the LECs would be permitted to bundle together services

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[205] Bell Atlantic Comments, p. 29, n.92.

[206] Id.

[207] BellSouth Comments, p. 69.

[208] Any argument that the Commission's Open Network Architecture ("ONA") paradigm provides ample unbundling is readily addressed by admissions such as Pacific's that "Pacific Bell's and Nevada Bell's interstate ONA BSEs brought in a combined total of $424 in 1993. (No zeros have been left off this figure.)" Pacific Telesis Comments, p. 69.

that face unequal levels of competition. Because LECs have the incentive to discriminate against potential competitors -- and have demonstrated this on numerous occasions[209] -- the opportunities for them to do so must be eliminated. So long as LECs maintain monopoly control of the local loop[210] and switching, this threat must be constrained by Commission oversight and regulation.

Nor, as MCI noted supra, have the LECs offered any evidence of incidences in which the current Part 69 rate structure has actually impeded their offering of new services. Further, MCI is not even aware of any delays in new service introductions that could be attributable to the existing Part 69 tariff process.[211] As the International Communications Association, Inc. remarks, "[s]ome of the 'delays' in introducing new services of which the LECs complain are the product of the LECs' experimentation with many different cost formula-

[209] Expanded Interconnection Tariff Suspension Order, Special Access, DA 93-657, released June 9, 1993 (Com. Car. Bur.)(Ordering reductios in expanded interconnection rates).

[210] Pacific's senseless contention that "about one-third of California businesses receive their dial tone from a PBX" (Pacific Telesis Comments, p. 72) should be dismissed when analyzing the degree of competition in the local loop since it leaves unanswered the obvious question: where do the PBXs get their dial tone?

[211] Recently, Part 69 restructuring has been the subject of numerous entreaties to the Commission. MCI continues to believe that resolution of this issue is best left to a separate docket that focuses on the sole issue of rate structure. Since the price cap plan functions as a vehicle for tariff review and is independent of any particular rate structure, MCI submits that it is inappropriate to resolve rate structure parity issues in the instant proceeding.

tions, claims about the 'proprietary' nature of cost model and other factors."[212] To the extent that the Part 69 rules may be a factor that disadvantages LECs vis-a-vis CAPs in the introduction of new services, the LECs have failed to pinpoint the cause of delays to the Commission's rules exclusively. Thus, any analysis that balances the need for regulation against the burden the LECs might face must be settled in favor of retention of rate structure rules.

As MCI noted supra, the LECs similarly contend that the current tariff requirements make it difficult for them to respond to the changing market. NYNEX, for example, states that "[t]he Commission's disparate tariff requirements also place LECs at a serious competitive disadvantage."[213] USTA remarks that "[d]isparity between LEC and CAP tariff notice periods not only makes it difficult for LECs to meet the needs of customers in a timely manner, it provides LEC competitors with advance notice of LEC offerings which is generally not otherwise available in competitive markets."[214] Bell Atlantic seeks tariff parity with the CAPs: "LECs should have the same flexibility as their competitors to quickly introduce new services -- including filing new service tariffs on one day's notice."[215]

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[212] International Communications Association, Inc. Comments, p. 20.

[213] NYNEX Comments, p. 51.

[214] USTA Comments, pp. 90-91.

[215] Bell Atlantic Comments, p. 29 (footnote omitted).

There simply is no requirement that the Commission adopt and maintain tariff filing parity among different classifications of carriers.[216]

The LECs further lament the disparity between the depreciation rates the Commission prescribes for them, and the rates that other industry participants set for themselves.[217] The LECs argue that if the sharing mechanism is eliminated, the need for Commission-ordained depreciation rates become anachronistic because the level of carriers' expenses is moot when excess profits need not be calculated.[218] They seek elimination of affiliate transaction rules on the same basis.[219] Such reasoning, however, dissolves upon closer scrutiny.

The LECs would ask the Commission to open wide doors through which their non-regulated operations could funnel costs to the regulated telephone company. Yet, elimination of the sharing mechanism does not diminish the Commission's statutory responsibility to ensure that the LECs' regulated rates remain reasonable and compensatory.[220] If the CAPs fail to achieve reasonable

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[216] See also MCI v. AT&T, Nos. 93-356 and 93-521, slip op. at 17 (U.S. June 17, 1994)(holding Commission can modify tariff filing requirements that stop short of introducing new regulatory regime).

[217] See, e.g., Ameritech Comments, p. 13; BellSouth Comments, p. 40; Pacific Telesis Comments, p. 30; USTA Comments, p. 91; and US WEST Comments, p. 41.

[218] Bell Atlantic Comments, p. 8; Southwestern Bell Comments, p. 46; and US WEST Comments, p. 67.

[219] BellSouth Comments, p. 74; Southwestern Bell Comments, p. 46; and US WEST Comments, p. 67.

[220] Elimination of sharing would drastically curtail the Commission's enforcement clout, as noted supra, Baseline Issue 4b.

profits, their shareholders will have to suffer the consequences. If the LECs' profitability fell precipitously, the Commission could grant them relief by allowing above-cap rates. If the LECs imprudent non-regulated investments (from which, under the LECs' scenario, the regulated operations would no longer be fully insulated) placed them in grave financial risk, the Commission's failure to grant them relief while maintaining their carrier-of-last resort obligation might implicate the "just compensation" clause of the Fifth Amendment. So long as the Commission retains the statutory duty to ensure that LECs may achieve a reasonable rate of return, they must retain the rules under which the LECs' regulated profits are determined.

BASELINE ISSUE 10: SALES AND SWAPS OF EXCHANGES

Whether, and how, the process for granting waivers of the price cap rules governing mergers and acquisitions or the price cap rules themselves should be revised so as to prevent unreasonable cost shifting and maintain the efficiency incentives of the LEC price cap plan.

In its comments, MCI recommended an exogenous cost methodology that would allow the Commission to freely grant a waiver of the "all-or-nothing" merger and acquisition rule that was designed to prevent price cap LECs from divesting themselves of high cost exchanges in ways that artificially inflated either access rates or Universal Service Fund payments. That is, MCI urged the Commission to require LECs either to demonstrate that there will be no effect on interstate access rates or subsidies as a result of the sales, or to take exogenous adjustments to offset the increase. Specifically, MCI suggested exogenous cost offsets equal to the additional subsidies the purchasing carriers receive from the "triple-DEM weighting" and increased Universal Service Fund payments. In addition, the selling price cap LECs would reduce their price cap indexes for the changes in their costs due to the sales of the high cost exchanges.[221]

In its comments, AT&T confirmed MCI's assertion that "the advent of price cap regulation has created new and powerful economic incentives for price cap LECs selectively to sell high cost local exchanges in their service territories to other carriers."[222] Thus, AT&T advocated a rule change similar to MCI's proposal whereby "the selling carrier should be required to flow through cost savings [derived from divesting itself of high cost exchanges] directly to its customers through an exogenous change to its PCIs."[223] The Commission must adopt a mechanism that encourages those swaps or sales of exchanges that are motivated by good business purposes, while preventing those exchanges that are pursued in order to achieve an artificial productivity gain or increase in Universal Service Fund support.

Rather than adopt a particular guideline for granting waivers of the all-or-nothing rule, many of the LECs recommend that the Commission analyze such

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[221] MCI Comments, p. 61.

[222] AT&T Comments, pp. 49-50. See also MCI Comments, pp. 61-62.

[223] AT&T Comments, p. 51 (footnote omitted).

arrangements on a case-by-case basis.[224] Although individual transactions may present unique sets of circumstances, the rule that MCI urges the Commission to adopt is preferable to the LECs' basic suggestion that the Commission adopt no rule at all. If there is no set rule, it will make transactions for the swap or sale of exchanges very difficult to contemplate. This is because the parties involved in negotiations cannot assume the probable outcomes of their petitions for waiver. Not only would such uncertainty dissuade parties from engaging in potentially beneficial transactions, but it would add extra cost to LECs' operations and lower the productivity of those LECs who pursued deals that had no chance of being consummated.

Contrasted to the ad hoc approach supported by many LECs, MCI's proposal is simple to administer, encourages transactions supported by good business reasons, and discourages those that carriers pursue simply to game the subsidy and cap mechanisms. Regardless of the waiver process or criterion the Commission adopts, it must ensure that LECs do not achieve productivity gains or economic windfalls at the expense of the IXCs. That is, a LEC that is divesting itself of a high-cost property must reflect the commensurate increase in productivity it realizes from the sale by lowering its price cap indexes accordingly. Similarly, there must be a mechanism that protects IXCs against potential increases in Universal Service Fund just because a LEC property changes hands.

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[224] See, e.g., BellSouth Comments, p. 79; GTE Comments, p. 80; Rochester Telephone Corporation Comments, p. 24; and USTA Comments, pp. 93-94 (footnote omitted).

Unless a specific rule is adopted to ensure that IXCs are equally protected on all transactions, the flexibility of a case-by-case approach could put the IXCs at risk of being unjustly burdened with these additional and LEC-manufactured non-economic costs.

BASELINE ISSUE 11: OTHER REVISIONS TO THE CURRENT LEC PRICE CAP PLAN

Whether the Commission should adopt revisions to the baseline LEC price cap plan in areas other than those specifically discussed in this Notice.

Several parties commenting in this proceeding recommend that the Commission replace the inflation factor currently used in the price cap formula, GNP-PI, with a different factor, GDP-PI.[225] Though the factors are theoretically different, in practice there is no material difference between them except that the Commerce Department releases a 45-day estimate of the GDP-PI, but not of the GNP-PI. Thus, the GDP-PI can more readily be incorporated into the annual access filing on a timely basis. MCI does not object to this modification.

BASELINE ISSUE 12: RELATIONSHIP TO OTHER PROCEEDINGS

How the Commission should coordinate the LEC price cap review and any changes in the LEC price cap plan with other proceedings and proposals.

While there are numerous issues before the Commission whose resolution may depend upon decisions the Commission makes in the instant proceeding,

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[225] See, e.g., NYNEX Comments, p. 214; Pacific Telesis Comments, p. 34; and Southwestern Bell Comments, p. 65.

MCI does not believe that it is wise to attempt to bundle them in a single proceeding. Though many of them may have major impacts on the price cap plan, however, it is virtually impossible to resolve the price cap plan in a way that anticipates potential outcomes of these tangential proceedings. As MCI noted in its comments, "the Commission cannot fashion price cap rules to accommodate yet-undecided outcomes of other proceedings."[226] Sprint agrees that the changes to the price cap plan that it has recommended "can and should be made without awaiting the initiation and/or completion of other, related proceedings."[227] The International Communications Association agrees that modifications to other proceedings are not appropriate "at this time."[228] The Commission should stick to its knitting and answer the open price cap issues on the basis of today's regulatory environment. As external factors change, it can address specific facets of the price cap plan to accommodate the evolving environment.

Other commenting parties, however, believe adoption of changes that they recommend the Commission make to the price cap plan will allow the immediate elimination of other Commission regulations without necessarily concluding all open investigations. That is, if the Commission "eliminates the last vestiges of rate of return regulation by eliminating the sharing and low-end adjustment

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[226] MCI Comments, p. 63.

[227] Sprint Comments, p. 23 (footnote omitted).

[228] International Communications Association, Inc. Comments, p. 24.

mechanisms,"[229] it can relax numerous other current rules. Specifically, several LECs believe that this change in the price cap plan would open the way for it to allow the LECs to accelerate their capital recovery plans and be free from affiliate transaction rules. Additionally, they argue, the proceedings in which the add-back issue and judgments and litigation costs are being considered, could be terminated.

The LECs almost unanimously use the proceeding to seek the depreciation simplification methodology the Commission recently has denied them.[230] First, USTA contends that "[t]his proceeding is also linked to the Commission's ability to achieve depreciation reform in CC Docket 92-296."[231] NYNEX appeals to the Commission for "revised capital recovery rules for LECs."[232] Further, Southwestern Bell believes that "[d]epreciation reform should also occur."[233]

Similarly, LECs argue against both the current and proposed more strict affiliate transaction rules. USTA submits that:

> the affiliate transaction rules are not necessary to prevent cross-subsidization under price cap regulation so long as price caps are fully severed from the last remnants of rate of return regulation, in particular the sharing mechanism. Accordingly, the Commission

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[229] US WEST Comments, p. 67.

[230] See Bell Atlantic Comments, p. 8; BellSouth Comments, p. 73; NYNEX Comments, p. 67; Pacific Telesis Comments, p. 48; and Southwestern Bell Comments, p. 57.

[231] USTA Comments, p. 103 (footnote omitted).

[232] NYNEX Comments, p. 67.

[233] Southwestern Bell Comments, p. 92.

should eliminate the sharing mechanism and withdraw the affiliate transaction rules for price cap LECs.[234]

BellSouth agrees: the "onerous new accounting rules" that the Commission has proposed in CC Docket No. 93-251, Affiliate Transactions . . . [would be] virtually meaningless under a pure price cap regulation regime." Adoption of such a plan would allow the Commission to "dispose of those proceedings without further consideration."[235]

MCI advises against the elimination of the sharing mechanism.[236] If the Commission nonetheless abolishes sharing, it should recognize that its absence does not mitigate the LECs' opportunities to continue to engage in cross-subsidization of competitive services or predatory pricing. Moreover, the Commission must recognize that its obligation to set depreciation rates is statutory, and cannot be ignored.

The practical effect of eliminating both the sharing mechanism and the affiliate transaction or depreciation prescription rules would be to grant the LECs carte blanche, allowing them to game the system. First, the LECs could install new facilities to support competitive services. Even though current plant might be sufficient for the monopoly services, if the LECs had virtual control over their depreciation rates, they could report exorbitant depreciation expenses that could

[234] USTA Comments, pp. 104-105.

[235] BellSouth Comments, pp. 72-74 (footnote omitted).

[236] If the Commission sets the productivity factor at the appropriate level (e.g., 5.9%), MCI believes the lower formula adjustment mechanism is no longer necessary.

result in earnings levels that were quite low, confounding the Commission's ability to judge overall LEC performance under price cap. Similarly, the LECs' affiliates could fashion transfers of plant or provision of services in such a way that the brunt of the cost fell on the LECs, thereby producing an apparent reduction in regulatory earnings. Thus, the LECs have the ability and incentive to either use monopoly profits or load expenses onto the monopoly services to pursue non-competitive ventures to the detriment of their monopoly ratepayers. The Commission must retain the affiliate transaction and depreciation rules.

Further, many LECs raise issues that simply are beyond the scope of the price cap review. Such matters should be resolved in the dedicated on-going (or announced) investigations, rather than raised in a proceeding that basically focus on the tariff review mechanism. For example, USTA submits, that "competitive alternatives exist for operator services, and there is no reason to impose additional restrictions on LEC pricing for these service by creating a new service category."[237] The Commission should resolve this Part 69 revision issue in CC Docket No. 93-124, Treatment of Operator Services Under Price Cap Regulation. USTA's laundry list also includes incorporation of "the recommendations made in USTA's [Part 69] Petition so that the appropriate changes can be implemented effective January 1, 1995."[238] The appropriate response to USTA's comments is to refer Part 69 issues to a future Part 69 proceeding. Nor should the Commis-

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[237] USTA Comments, p. 105.

[238] Id. at 102-103.

sion halt proceedings that are ongoing without reviewing the record and reaching a conclusion on the open issues based on their own merits. Finally, MCI agrees with those parties who contend that universal service issues should be settled outside of this price cap review.[239] To the extent that any decisions made in the anticipated universal service docket require modifications to the price cap plan, they can be enacted at a later date. In sum, price caps should not be the driver of universal service issues -- or any other policy matter the LECs have raised in their comments.

TRANSITION ISSUE 1: CRITERIA FOR REDUCED OR STREAMLINED REGULATION OF CAP PRICES

Transition Issue 1a: The Current State of Competition for Local Exchange and Interstate Access.

MCI's comments demonstrated that the LECs are de facto monopolists.[240] CAPs -- the only real competitors of the LECs today -- serve a minuscule portion of the market. Cellular radio is not a practical substitute for land-line telephone service. PCS shows promise as a competitive technology, but faces a number of barriers, including capacity restrictions, spectrum limitations and regulatory delay. The provision of telephone service over cable television facilities is only now being tested. The conclusion that LECs face no real competition was

[239] See, e.g., BellSouth Comments, pp. 72-73; and Southwestern Bell Comments, p. 95.

[240] MCI Comments, p. 64.

echoed in the comments of LEC customers, consumer groups, consumer advocates, as well as the few competitors that are in the market.[241]

Many of the LECs wrote essays on "convergence" and the role future technologies may play in telecommunications markets. As these reply comments show, however, the prospects for future competition are just that -- prospects. Today's access market -- the primary market to which the price cap regulatory scheme being evaluated in this proceeding applies -- is dominated by the LECs. This will remain true for years to come. These are the years in which the next version of the price cap plan will be in effect. Today's access customers must be protected from excessive and discriminatory access charges during the transition to a more competitive market.

MCI's comments pointed out that the CAPs represent less than 1 percent of the access purchased by IXCs.[242] Several LECs argue that the CAP market presence is actually larger because customers may provide their own access.[243] The problem with this argument is that even if customer supplied access is considered, the CAPs still have only a tiny fraction of the market.

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[241] See, e.g., Office of the Consumer Advocate, Commonwealth of Pennsylvania Comments, p. 3; Office of Consumers' Counsel, State of Ohio Comments, p. 13; Wiltel Comments, pp. 34-35; Comptel Comments, p. 4; AT&T Comments, pp. 9-14; Association for Local Telecommunications Services Comments, pp. 11-34; Ad Hoc Telecommunications Users Committee Comments, p. 32; Teleport Comments, p. 16; and MFS Communications, Inc. Comments, p. 37.

[242] MCI Comments, p. 65.

[243] See GTE Comments, p. 51.

Customers may, of course, provide their own microwave radio or even fiber links to an IXC point-of-presence ("POP"). Microwave technology has been available to large companies since the Above 890 decision in 1959. However, most customers, even large customers, do not want to be in the telecommunications business. Increasing interexchange competition has led many large customers to abandon their own private networks in favor of virtual networks. What this means is that, as a practical matter, if customers do want to supply their own access to an IXC POP, they are likely to rely on the CAPs to do it for them.[244]

In 1993, Connecticut Research reported that IXC POP to end user access revenues of the CAPs were $87 million.[245] This compares with access revenues of approximately $25 billion for the LECs. In other words, the CAPs had less than 1 percent of the market even using the metric preferred by the LECs.

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[244] Peter Huber, "The Enduring Myth of the Local Bottleneck," is cited by USTA for the proposition that there is substantial present competition for the LECs. Huber argues that private microwave is a significant competitor because microwave has been available for a long time and the facilities last many years (see p. 36, note 91). However, in his 1987 Report, published before he began working for the BOCs, Huber reported the results of several surveys, including one by the Commission in 1985 that found that facilities bypass "was not then a significant occurrence." See "The Geodesic Network, 1987 Report on Competition in the Telephone Industry," January 1987, Appendix E. The 1987 Huber Report also points out that "about 0.2 percent of AT&T's private line customers elected to arrange their own access to the local AT&T POP, and all but a handful used LEC facilities in doing so." p. 3.26.

[245] See "Access Revenue by Application," Connecticut Research Report on: Competitive Telecommunications, January 1, 1994, p. 5.

Even this measure overstates the presence of the CAPs because much of the business generated by the CAPs does not displace LEC business. Rather, CAP services are used to provide redundancy for the LEC facilities or to provide services the LECs failed to provide.[246] Viewed alternatively, the CAPs have expanded the market.

The LECs claim that the market is already highly competitive, despite the tiny market share of the CAPs. Rather than providing real empirical evidence for this proposition, many LECs offer laundry lists of cities in which CAPs have built or are planning to build facilities. While these lists might appear impressive, they serve only to highlight the obvious fact that there are many more cities in which access customers have no alternatives to the LECs.

Moreover, as discussed below, presence in a city does not mean that the access market in the city is competitive. CAPs serve only a small fraction of the customers. As AT&T points out, the CAPs serve fewer than 3,000 buildings throughout the country.[247]

Several LECs rely on survey results to argue that CAPs have obtained a substantial amount of business from their largest customers.[248] These survey results are highly suspect. First, even if the survey technique relies on random

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[246] See Teleport Comments, pp. 21-22.

[247] See AT&T Comments, p. 10.

[248] See, e.g., USTA Comments, Appendix B, Robert G. Harris, "Economic Benefits of LEC Price Cap Reforms," p. B-6 (citing surveys by Quality Strategies); Pacific Telesis Comments, p. 76; and Ameritech Comments, Attachment B.

samples of customers, customers who do not use alternative access facilities are unlikely to respond. It is questionable whether these companies have anyone on their staff to whom the calls can be referred.[249] Second, if the LECs are bleeding so badly from competition, as their discussions of survey results suggest, why do their access revenues continue to grow quarter after quarter?[250] Finally, even if taken at face value, the surveys simply reveal what we already know. In some cities the CAPs have attracted customers for their dedicated circuits from among the largest businesses. The vast majority of all customers do not have competitive alternatives.

Pacific Telesis tries to impress the Commission with the presence of CAPs by pointing out that Teleport has installed a 5ESS switch in San Francisco and MFS has put California on the "short list" for a Class 5 switch.[251] Commission data show that in 1993, Pacific Telesis had 1,229 switches.[252]

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[249] For example, in a Quality Strategies survey recently conducted for Ameritech, Douglas Young reports that "often interviewers contact multiple persons within a business account in order to find the most knowledgeable person regarding telecommunications billing. In most cases, the person surveyed was the telecommunications manager." Filed in Illinois Commerce Commission Docket Nos. 93-0409, 94-0096, March 25, 1994, pp. 6-7.

[250] "All major indicators of growth for the Bell RHC telephone segments showed strong gains that were better than expected." Stephanie Comfort, "Bell Regional Holding Companies First Quarter Review," April 25, 1994, p. 1.

[251] See Pacific Telesis Comments, p. 74.

[252] See Monitoring Report, CC Docket No. 87-339, May 1994, p. 427 (includes host remote switches). Pacific also noted in its comments in the instant proceeding that "[i]t demonstrates nothing about market power, for example, to observe that CAPs have deployed only 131,000 miles of fiber nationwide, while LECs have deployed 5,504,370." Pacific Telesis Comments,